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ABSTRACT

This booklet for trustees of higher education institutions offers guidelines to help trustees understand the institution's financial statements. Individual sections describe the three major financial statements and cover topics such as: (1) standards of the Financial Accounting Standards Board; (2) the "statement of financial position," which summarizes assets, liabilities, and net assets; (3) the key strategic issue for trustees in evaluating the statement of financial position, which is determining whether existing resources will enable the institution to fulfill its mission; (4) the "statement of activities," which reviews changes in the institution's net worth; (5) the key strategic issue for trustees in evaluating the statement of activities, which is how effectively did the institution use its resources to provide services to its constituents; (6) the "statement of cash flow," which assesses the institution's ability to meet ongoing cash needs; and (7) the key strategic issue for trustees in evaluating the statement of cash flow, which is determining the institution's sources and uses of cash; and (8) assessing the external market in order to understand who is the audience for the institution's financial statements and what are its information needs. Examples of the three statements for a hypothetical institution are provided. (DB)

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ED 428 594

BOARD BASICS

FINANCIAL MATTERS

UNDERSTANDING FINANCIAL STATEMENTS

BY JOHN H. MCCARTHY AND
ROBERT M. TURNER, WITH
SANDRA L. JOHNSON, EDITOR

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ASSOCIATION OF GOVERNING BOARDS OF UNIVERSITIES AND COLLEGES

John H. McCarthy

John H. McCarthy is a senior partner of Coopers & Lybrand L.L.P. and the national chairman of the Education and Nonprofit Industry for New England and Upstate New York. He is the author of several monographs, including *Financial Reporting and Contributions: A Donor's Guide to FASB Nos. 116 and 117*, a publication he co-authored with Robert M. Turner. McCarthy is the past president of the Massachusetts Society of CPAs and a longtime member of the American Institute of Certified Public Accountants Governing Council. He has taught at Boston College and the University of Michigan Business School.

Robert M. Turner

Robert M. Turner is the Lowell Schoolman Term Chair and associate professor of accounting at Babson College, where he teaches financial accounting. He is the author of several articles and monographs on financial reporting, including *Reinventing the Enterprise: Managing and Financing Institutions of Higher Education*, of which Sandra Johnson was co-editor. Turner is a member of the American Accounting Association and the Massachusetts Society of CPAs. He has degrees from LeMoyne College, Syracuse University, Boston College, and Boston University.

Sandra L. Johnson

Sandra L. Johnson is a director of Coopers & Lybrand L.L.P.'s National Education Group, which coordinates the firm's services to colleges and universities. She is the editor of *Understanding Financial Statements: A Strategic Guide for Independent College and University Boards*, written by McCarthy and Turner.

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Understanding Financial Statements

To make informed decisions, college and university trustees need reliable financial information. One important source of such information is the institution's annual audited financial statements and the notes that accompany them.

At a basic level, financial statements describe the institution's assets and liabilities, operating results, and cash flows. More broadly, they present a picture of the institution's financial health and show how its resources have been used over the year. Financial statements are important vehicles for communicating an institution's financial story. They are assessment tools not only for institutions and trustees but also for such external constituents as donors, rating agencies, investors, banks, regulators, parents, prospective students, and others. Trustees—ultimately responsible for the financial health of the institutions they serve—are responsible for understanding the story the financial statements tell and clarifying it for constituents.

Reading and understanding an institution's annual financial statements can be daunting; however, trustees should be familiar with the basic contents of these statements and how to interpret them. Of course, some trustees have more financial expertise than others. Those who do (and who typically find themselves serving on the finance or audit committee) are responsible for sharing their understanding of financial and audit matters with the other board members.

Standards for Financial Statements. In the 1970s, the Financial Accounting Standards Board (FASB), the accounting standard-setting body for corporations and nonprofit organizations, developed a conceptual framework for financial reporting. At that time, it issued two concept statements that underlie all FASB standards relating to nonprofit organizations, including private colleges and universities.

The first, known as the Statement of Financial Accounting Concepts (SFAC) No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations," states that external financial reporting should focus on giving people the information they need to make decisions regarding the organization. That is, nonprofit organizations should present financial information that will help trustees, administrators, donors, and other constituents with these tasks:

- making rational decisions about the organization's allocation of resources,
- assessing its services and its ability to continue to provide them,
- assessing how its managers have performed their stewardship functions,
- analyzing its economic resources and obligations, and
- evaluating its service efforts and accomplishments as performance indicators.

The second concept statement, SFAC No. 6, "Elements of Financial Statements," defines seven "elements" these financial statements should cover: assets, liabilities, net assets, revenues, expenses, gains, and losses. The statement further distinguishes three categories of net assets according to whether they involved donor-imposed restrictions.

SFAC Nos. 4 and 6 provided a foundation for two later FASB pronouncements: Statement of Financial Accounting Standards (SFAS) No. 116, "Accounting for Contributions Received and Contributions Made," and SFAS No. 117, "Financial Statements of Nonprofit Organizations." These statements, issued in June 1993, are now in effect for all private colleges and universities.

FINANCIAL STATEMENTS FOR NONPROFIT ORGANIZATIONS NOW ARE SIMILAR IN FORM TO THOSE OF FOR-PROFIT ORGANIZATIONS.

SFAS Nos. 116 and 117 have resulted in major changes in the way nonprofit organizations report their financial results to the public. Those who need or want to understand the financial condition of an institution have to reeducate themselves on both the form and content of the institution's statements. Financial statements for nonprofit organizations now are similar in form to those of for-profit organizations; the primary difference is that a nonprofit organization receives and reports contributions.

Before this shift, financial statements typically used a method called fund accounting, which focused on stewardship of various funds. The new standards categorize assets not by fund but according to their availability for use by the institution. This gives the reader a better view of the financial viability, liquidity, and solvency of the institution as a whole.

SFAS No. 116 clarifies the definition of contributions and when the organization should recognize particular contributions as revenue. SFAS No. 117 requires an organization to present three financial statements: a statement of financial position, a statement of activities, and a statement of cash flows. This required format helps the reader view the institution's total financial condition in terms of its assets and liabilities, its revenues and expenses, and its cash flows—information that often was difficult to discern in the fund-accounting model. Descriptions of the three financial statements follow.

THE STATEMENT OF FINANCIAL POSITION. The statement of financial position, or balance sheet, is a snapshot of the financial condition of the institution as a whole at a specific time, generally the end of the fiscal year. The statement of financial position must display the following amounts: total assets, total liabilities, total net assets, and totals for each of the three classes of net assets. These include unrestricted, temporarily

MOST INSTITUTIONS AGGREGATE ALL ASSETS OF EACH TYPE, PRESENTING THE FINANCIAL STATEMENTS IN A HIGHLY CONDENSED AND MEANINGFUL FORMAT.

restricted (such as term endowments and other assets restricted for a specific time or purpose), and permanently restricted (such as true endowment funds).

The distinctions "temporarily restricted" and "permanently restricted" must reflect restrictions imposed by donors or law, not those designated by the board. If the net asset has no donor-imposed restrictions, the statement of financial position should classify it as unrestricted. Institutions can, however, disclose self-imposed limitations (such as quasi-endowment or amounts designated for other specified areas) in the statement's footnotes or on the face of its statement of financial position within unrestricted net assets..

Most institutions aggregate all assets of each type, presenting the financial statements in a highly condensed and meaningful format similar to that of a commercial enterprise. For example, such statements usually present cash as a single, total amount, rather than a separate amount by fund. Similarly, investments frequently appear as a single number, providing a clear picture of the resources of the institution. The various liabilities of the institution also appear in a condensed format, so readers may easily determine the total short-term and long-term obligations of the institution.

Exhibit A illustrates a Statement of Financial Position for the hypothetical SanJo University. This statement displays the assets, liabilities, and net assets of the institution in a fairly simple and understandable format. In addition to fiscal 1996 totals, it includes totals for fiscal 1995 for comparison. Although some institutions simply present a total for each of the three net-asset classes on the face of this statement, many provide readers with subcategories of net assets. Most institutions provide further breakdowns of net assets in the statement of financial position itself or in separate charts or the financial statement footnotes.

EXHIBIT A

SanJo University
Statement of Financial Position
June 30, 1996 and 1995 (in thousands)

Assets	**1996**	**1995**
Cash and cash equivalents	$14,866	$15,650
Accounts receivable, net	1,010	851
Short-term investments	11,993	11,326
Inventories	1,109	1,062
Prepaid expenses and other assets	2,095	2,148
Pledges receivable, net	15,333	15,285
Student loans receivable, net	2,716	2,764
Long-term investments, at market	249,152	240,743
Land, buildings and equipment, net	109,626	96,211
Total assets	$407,900	$386,040
Liabilities		
Accounts payable and accrued expenses	5,903	7,188
Deposits and deferred revenues	2,897	2,759
Postretirement benefits	6,312	6,029
Federal student loan funds	2,831	2,782
Long-term debt	48,579	49,720
Total liabilities	66,522	68,478
Net Assets		
Unrestricted	157,212	147,341
Temporarily restricted	103,537	93,522
Permanently restricted	80,664	76,699
Total net assets	341,413	317,562
Total liabilities and net assets	$407,935	$386,040

For instance, a breakdown of unrestricted net assets can show which of those assets already have been committed to operating needs, so the reader does not mistakenly think large amounts of unrestricted funds are available for use. Unrestricted net assets include such things as an institution's net investment in plant (its property, plant, and equipment, less related debt); funds that the board or administrators have designated for the institution's specific current or future needs; and quasi-endowment funds designated by the board from unrestricted sources to serve as part of the institution's capital.

The Key Strategic Issue. Readers should review a statement of financial position with this strategic question in mind: *Are existing resources sufficient to enable the institution to fulfill its mission?* The FASB notes specifically that this statement should tell users about an institution's ongoing ability to provide services and also about its liquidity, financial flexibility, and financing needs.

Of these points, liquidity is easiest to determine at a glance. The FASB defines liquidity as "an asset's or liability's nearness to cash," and it encourages colleges and universities to show liquidity in this statement by one of the following three methods: by classifying assets as current or noncurrent, by disclosing information about liquidity in the footnotes, or by sequencing assets according to their nearness of conversion to cash and liabilities according to their nearness to maturity and resulting use of cash.

Information on the institution's ongoing ability to provide services, demonstrate financial flexibility, and meet its financing needs generally relates to the institution's financial strength. One simple indicator of an institution's financial strength that appears in this statement is the growth in net assets and in each category of net assets. More complex approaches to the data (for example, relating it to information provided in the statement of activities) will provide even greater insight into the institution's sufficiency of resources.

READERS SHOULD REVIEW A STATEMENT OF FINANCIAL POSITION WITH THIS STRATEGIC QUESTION IN MIND: ARE EXISTING RESOURCES SUFFICIENT TO ENABLE THE INSTITUTION TO FULFILL ITS MISSION?

THE STATEMENT OF ACTIVITIES. This statement basically is the institution's statement of changes in its net worth, including information normally presented in the income statement. It describes the changes in net assets and the ways in which the institution has used these resources to provide services during the previous year. It enables institutional officials and others not only to assess whether the college or university is operating within its available resources but also, in many cases, to evaluate the costs of operating various programs. The FASB has established these basic requirements for the statement of activities:

- The statement must report the total amount of the changes in each of the net-asset groups (unrestricted, temporarily restricted, and permanently restricted net assets).
- The statement must show the amount of the total changes in all net assets for the period.
- The statement must show all expenses as if expended from unrestricted net assets.

To the extent that temporarily restricted net assets are available to meet current expenses, they must be shown as having been "released" from restrictions and reclassified into unrestricted resources. The FASB allows for a great deal of flexibility in the statement of activities. SFAS No. 117 states that as long as an institution meets the minimum requirements, it may classify items as "operating and nonoperating, expendable and nonexpendable, earned and unearned, recurring and nonrecurring, or in other ways." Because the FASB did not prescribe a single format for the statement of activities, institutions have used many different formats. Even so, the new statement of activities is easier to understand than its predecessor, which reported financial information by funds.

EXHIBIT B

ANALYZING THE STATEMENT OF ACTIVITIES

Statement of Activities
"For The Year Ended June 30,1996 with comparative totals for 1995 "
(In Thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	1996 Total	1995 Total
Operating Revenues					
Tuition and fees	$54,298			$54,298	$49,077
University sponsored financial aid	(5,145)			(5,145)	(4,446)
Donor sponsored financial aid	(9,988)			(9,988)	(8,892)
Net tuition and fees	39,165			39,165	35,739
Sales and services of auxiliaries	12,099			12,099	10,628
Government grants and contributions	1,991			1,991	1,684
Private gifts and grants	4,084	2,639		6,723	5,647
Long-term investment Income	4,110	4,943		9,053	10,152
Investment gains used for operations	1,191	1,456		2,647	963
Other income	1,314			1,314	1,285
Net assets released from restrictions	6,266	(6,266)			
Total operating revenues	70,220	2,772		72,992	66,098
Operating Expenses					
Instruction and research	27,619			27,619	25,783
Athletics	6,001			6,001	5,499
Academic support	6,367			6,367	6,321
Student services	6,085			6,085	5,643
Institutional support	10,648			10,648	10,472
Auxiliaries enterprises	10,020			10,020	8,845
Total operating expenses	66,740			66,74C	62,563
Increase in net assets from operating activities	3,480	2,772		6,252	3,535
Non-Operating Activities					
Investment gains reinvested	5,024	8,174		13,198	1,793
Capital gifts	934	1,921	3,965	6,820	8,511
Other	(1,197)	(1,223)		(2,420)	(969)
Net assets released from restrictions	1,629	(1,629)			
Increase in net assets from non-operating activities	6,390	7,243	3,965	17,598	9,335
Net increase in net assets for the year before change in accounting	9,870	10,015	3,965	23,850	12,870
Effect of changes in accounting:					
Contributions pledged					15,285
Postretirement benefits					(5,645)
Net increase in net assets	9,870	10,015	3,965	23,850	22,510
Net assets at beginning of year	147,342	93,522	76,699	317,563	295,052
Net assets at end of year	$157,212	$103,537	$80,664	$341,413	$317,562

The accompanying notes are an integral part of the financial statements.

Exhibit B portrays one popular format for a statement of activities. This statement contains four columns for fiscal year 1996 (Unrestricted, Temporarily Restricted, Permanently Restricted, and 1996 Total) and for comparison, another column for fiscal 1995 totals. SanJo's statement of activities has three sections—Operating Revenues, Operating Expenses, and Nonoperating Activities.

Overall, the statement of activities captures information about the operating activity of an institution, its investment-management results, and its fund-raising activities. Therefore, the four major areas most institutions measure in these statements are overall results, operating results, investment performance, and fund-raising results. The format the institution chooses can obscure or emphasize any or all of these important areas.

The Key Strategic Issue. The fundamental question the statement of activities answers is this: *How did the institution use its resources to provide services to its constituents?* To answer this, board members may want to consider the following:

1. *Overall, how did the institution perform financially for the year?* To measure financial performance, readers might examine the year's increase in net assets as a percentage of the beginning balance of net assets. The net assets should be increasing at a rate exceeding inflation—at a much quicker pace if the institution is to sustain real progress.

2. *Is the institution living within its means?* Readers should look at the change in net assets from operating activities. A net increase indicates that the institution's operating revenues exceeded its expenses, and the institution generally is living within its means. If it is not, institutional leaders must devise ways to close the deficit in the short term and create a surplus in future years.

3. *How reliant is the institution on each of its operating revenue sources?* Readers should look at each operating revenue source (tuition and fees, private gifts and grants, and so forth) as a percent of total operating revenues. The broader an institution's revenue stream, the less exposure it has to fluctuations in any one revenue source.

4. *Do operating expenses by category reflect institutional priorities?* To determine if an institution's spending patterns reflect its mission, readers should look at each cost category (instruction, institutional support, and so forth) as a percent of total operating expenses.

5. *How dependent was the institution on investment or endowment income and annual giving to meet its operating needs?* Readers should look at the data for private gifts and grants and for investment income as a percentage of total operating revenues. This shows the extent to which the institution depends on endowment investment and fund-raising and whether these revenue sources are sustainable.

6. *Do the auxiliary enterprises of the institution support their own costs?* Auxiliary services such as bookstores and food services should be self-supporting.

7. *How well did the institution manage its investments?* Data about investments presented in the statement itself and the accompanying footnotes should enable trustees to monitor the rate of return—that is, interest income and dividends plus net realized and unrealized gains (less related management and custodial expenses) as a percent of average market value.

8. *How well did the institution manage its fund-raising?* Depending on the statement's format, gift income may not be readily apparent. Unconditional pledges are recorded as contributions when the donor makes the commitment and appear in the financial statements at the present value of the amounts the institution expects to receive. That means the amounts listed as "gifts" or "contributions" in this statement generally are not the amount of cash the institution actually receives from donors during the period. On the other hand, the statement of activities measures contributions on the accrual basis, which should help readers assess an institution's overall fund-raising activities for the year. Also, the FASB requires the institution to disclose the cost of fund-raising either in the statement or in footnotes. Trustees should examine fund-raising costs as a percentage of gifts recorded.

Board members who want a deeper understanding of this statement must ask for a far more detailed analysis than the foregoing basic questions suggest. Lenders, rating agencies, and the institution's own administrators use other methods to perform such assessments.

THE STATEMENT OF CASH FLOW. This statement describes an institution's cash receipts and payments during a specific period. By studying the cash flow statement, board members and administrators can assess the institution's ability to meet its ongoing cash needs from operations or through other forms of financing.

Corporations have long been required to provide a statement of cash flows, but colleges and universities did not need to do so until the FASB adopted SFAS No. 117, which extended the requirement to nonprofit organizations. Before that, the fund accounting system included only a statement of changes in fund balances, which many users tried—without much success—to interpret as a funds flow statement of sorts. The new statement more precisely delineates the major cash flow activities of the institution.

The requirements for higher education institutions are very similar to those for commercial enterprises. In particular, the statement must divide cash flow information into three categories:

1. Cash flows from *operating activities* represents the total change in net assets, excluding changes that do not provide operating cash (such as gifts-in-kind), those that do not consume cash (such as depreciation), and those that increase net assets over the long term but not the institution's operating cash (such as new funds for endowment). The statement also takes into account certain changes in working capital (that is, changes in the institution's current assets and liabilities).

2. Cash flows from *investing activities* typically includes purchases and/or sales of plant, equipment, and investments.

3. Cash flows from *financing activities* generally include the issuance of long-term debt and the repayment of debt, as well as contributions received for long-term investment.

Taken together, these components equal the total change in the cash and cash equivalents reported in the statement of financial position. ("Cash and cash equivalents" includes all cash and short-term investments with a maturity of not more than 90 days at the time of purchase.)

EXHIBIT C

STATEMENT OF CASH FLOWS

SanJo University
Statement of Cash Flows
For the Years Ended June 30, 1996 and 1995

Cash Flows From Operating Activities	**1996**	**1995**
Change in net assets	$23,850	$22,510
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	4,684	3,866
Gains on investments	(15,845)	(2,756)
Gain on equipment disposals	(102)	(63)
Capital gifts	(5,886)	(7,151)
Other non-operating activity	1,698	257
Changes in assets and liabilities that provide (use) cash:		
Accounts receivable	(159)	(71)
Pledges receivable	(48)	(15,285)
Student loans receivable	48	46
Short(term investments	(667)	(221)
Inventories	(47)	(56)
Prepaid expenses and other assets	23	(74)
Accounts payable and accrued expenses	(1,285)	1,594
Deposits and deferred revenues	138	165
Postretirement benefits	283	6,029
Other changes	933	(14,78)
Net cash provided by operating activities	7,618	7,312
Cash Flows From Investing Activities		
Purchases of plant and equipment, net	(18,016)	(18,909)
Purchases of investments	(265,934)	(337,735)
Proceeds from sales and maturities of investments	272,501	336,969
Other non(operating activity	(16,98)	(257)
Net cash used in investing activities	(13,147)	(19,932)
Cash Flows From Financing Activities		
Proceeds from contributions for:		
Investment in endowment	3,965	4,851
Investment in long-lived assets	1,921	2,300
Proceeds from issuance of long-term debt		
Payments on long-term debt	(1,141)	(1,068)
Net cash provided by financing activities	4,745	6,083
Net decrease in cash and cash equivalents	(784)	(6,537)
Cash and cash equivalents , beginning of year	15,650	22,187
Cash and cash equivalents, end of year	$14,866	$15,650
Supplemental Data		
Noncash investing and financing activities--gifts in kind	$412	$580
Interest paid	$2,952	$2,114

The accompanying notes are an integral part of the financial statements.

These three categories appear in Exhibit C. The first section shows a surplus in net cash provided by operating activities, the second section summarizes the cash used in investing activities along with proceeds from investments, and the third section describes a surplus in cash provided by financing activities. The total for cash and cash equivalents at the end of the year corresponds to the same line item on the statement of financial position in Exhibit A. In this example, a fourth section of supplemental data describes noncash investing and financing activities (gifts in kind) and interest paid.

The Key Strategic Issue. The statement of cash flows answers this strategic question: *What are the institution's sources of cash, and how has it used them for operations, investing, and financing activities?* Readers can find the answers to this question by examining the total changes in operating activities, investing activities, and financing activities for the year. For example, if cash flows from operations are negative, that means the institution will need to be able to meet this deficit through nonoperating sources or loans. More detailed analysis also can help determine answers to more specific questions on cash flows—for instance, whether the institution has operating cash available for such important commitments as deferred-maintenance programs and debt servicing.

EXTERNAL MARKET ASSESSMENTS. Because colleges and universities accept funds from donors, foundations, and other external sources, institutional leaders must understand the information needs of these report users, many of whom who ask questions similar to those asked by persons who review statements of for-profit organizations. Lenders want to know whether they will be paid back, for example, and donors and foundation leaders want to know that the institution uses gift funds effectively and efficiently.

The external audience for college and university financial statements also includes rating agencies—such as Moody's Investors Service and Standard & Poor's—that assess the financial viability of higher education institutions. Of course, financial data constitutes only part of these agencies' total assessment of an institution. They also take into account environmental factors that affect an institution's financial health (such as governmental, economic, and demographic influences) and internal factors (such as admissions flexibility, student and faculty quality, market position, and management strategies).

Agencies' assessments are important especially when an institution is seeking additional funds for financing, foundation funding, or capital campaigns, for example. Equally important, however, are self-assessments of an institution's financial health. Comparative ratios and other measures that rating agencies use to analyze financial data can help boards and administrators monitor an institution's liquidity, solvency, financial strength and flexibility, and operating performance. Some types of ratios that can be useful in self-assessment (and often in external assessment, too) follow.

Operating ratios help determine whether an institution is living within its means. Over time, they also point to possibly significant changes in revenues and expenses. Information for operating ratios comes primarily from the statement of activities. For example, the ratio of operating revenue to educational and general expenses captures the degree to which an institution relies on net tuition and fees to meet its operating expenses. Debt-service ratios (such as the ratio of annual debt service to the total operating costs of the institution) help in gauging the institution's ability to meet its debt obligations.

Financial-strength ratios describe the solvency, financial flexibility, and long-term financial viability of an institution based on its debt and endowment. Information for financial-strength ratios comes from the statement of financial position and the statement of activities. For example, ratios that measure an institution's total endowment relative to its operating expenses show the institution's degree of financial flexibility—that is, its ability to tap its endowment to meet operating costs if its operating revenues decline.

Liquidity and cash-flow ratios rely on data from the statement of cash flows. For example, the ratio of operating cash flow to debt service measures the ability of an institution to meet its debt service obligations from operating cash flows. The ratio of pledges receivable to total net assets provides information on future cash flows.

Institutional leaders should bear in mind that although ratio analysis can capture some kinds of financial information, it does not provide complete answers to questions regarding a college or university's financial health. Qualitative factors offer other significant information. However, ratios can serve as "red flags," especially if a ratio is increasing or decreasing significantly or is out of line with the ratio of a peer institution. In

any case, board members who understand the ratios for their college or university—and the explanations behind their fluctuations—have a valuable tool at their disposal.

A Final Note. Annual financial statements are important vehicles for communicating a broad view of an institution's financial performance, and as such are key assessment tools not only for the institution and its trustees but also for donors, rating agencies, investors, banks, regulators, and parents and prospective students. As trustees gain a better understanding of how to read and interpret the data revealed in financial statements, they will become more effective in making financial decisions that affect their institutions.

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BOARD BASICS

This publication is part of **Board Basics**, an AGB series devoted to strengthening the effectiveness of governing boards and trustees. Board Basics comprises several topic clusters—The Fundamentals, Financial Matters, Fund-Raising, Academic Affairs, Leadership, Strategic Decisions, and Effective Committees—each of which contains several booklets. Several assumptions underlie the series:

- Academic trusteeship grows increasingly ambiguous, and trustees need concise, accessible, and focused information to help them carry out their complex fiduciary and stewardship responsibilities.
- Basic principles of trusteeship remain constant across higher education, regardless of institutional type, size, and mission. The series highlights these general principles to provide trustees with a core of knowledge they can apply to their individual institutions.
- The series addresses the distinguishing characteristics of academic trusteeship, especially as it differs in scope, substance, and focus from corporate directorships and other board service.

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One Dupont Circle • Suite 400
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